



# Exempt Organizations Technical Guide

## TG 3-4 Exempt Purpose, Scientific Organizations 501(c)(3)

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## **I. Overview**

- (1) This Exempt Organizations Technical Guide (TG) discusses tax law issues related to scientific purposes of organizations exempt under Section 501(c)(3) of the Internal Revenue Code of 1986.

## **A. Summary**

- (1) The following Issues being discussed in this document include:
  - a. Definition of scientific
  - b. Activities that further scientific purposes
  - c. Analysis techniques for determining whether activities further those purposes and
  - d. Other issues related to scientific purposes.
- (2) Other issues discussed include:
  - a. Private benefit, inurement and the assessment of intermediate sanctions under Section 4958
  - b. Unrelated business income (UBI) derived from research activities and exclusions from UBI under Section 512(b)(8).
- (3) Audit techniques discussed include:
  - a. Conducting the organizational and operational test
  - b. Identifying activities and determining if they further the organization's exempt purpose
  - c. Developing examination issues
  - d. Identifying and resolving private benefit and inurement issues
  - e. Assessing intermediate sanctions
  - f. Identifying and resolving UBI issues.

## **B. Exemption Requirements**

- (1) Organizations qualifying for federal income tax-exemption described under Section 501(c)(3) must meet several requirements including both an organizational and an operational test. These tests require an organization described under Section 501(c)(3) to be organized and operated exclusively to further Section 501(c)(3) purposes. Scientific purposes are among the exempt purposes specified in Section 501(c)(3).
- (2) Scientific research organizations (SRO) are organizations engaged primarily or exclusively in scientific research. Familiar examples of the scientific activities of Section 501(c)(3) organizations include:

- a. Medical research projects of hospitals
- b. Research programs of major colleges and universities.

### C. History of Scientific Purposes as Charitable Purposes

- (1) After the 16th Amendment to the United States Constitution allowing for the levying of income tax was ratified on February 3, 1913, Congress enacted the Revenue Act of 1913, Ch. 16, 38 Stat. 114, on October 3, 1913, also known as the Underwood Tariff Act. The act established “scientific” as a purpose that is exempt from federal income tax.
- (2) In 1939 Congress grouped and codified all tax legislation under Title 26 of the U.S. Code, which is referred to as the Internal Revenue Code of 1939. The IRC of 1939 provided that organizations pursuing scientific activities were exempt from taxation under Section 101(6).
- (3) Congress recodified the Code in 1954, as the Internal Revenue Code of 1954, and redesigned and reordered the code to designate organizations exempt from federal income tax under Section 501 where “scientific” remained an exempt purpose.
- (4) The Internal Revenue Code of 1986 is the most current iteration of the Code where Section 501(c)(3) provides for the exemption of income taxes for organizations organized and operated exclusively for “scientific” purposes.

### D. Relevant Terms

**Note:** The following terms are not expressly defined in tax law. The analysis of whether an organization is scientific doesn’t depend on dictionary definitions. Treasury Regulation (Treas. Reg.) 1.501(c)(3)-1(d)(5) states that “scientific” includes scientific research in the public interest. Treas. Reg. 1.501(c)(3)-1(d)(5)(ii) states, “the term “research” when taken alone is a word with various meanings, it is not synonymous with “scientific,” and the nature of particular research depends upon the purpose which it serves.” There is a history, however, of the courts applying general meaning or dictionary definitions when applying the terms and activities of science, scientific and research. The following dictionary terms are listed below to be used as a starting point. However, facts and circumstances will have the greatest impact of whether an activity is “scientific: and conducted “in the public interest.”

- (1) Science - the process by which knowledge is systematized or classified using observation, experimentation, or reasoning.
- (2) Basic science - knowledge or a system of knowledge covering general truths, or the operation of general laws especially as obtained and tested through the scientific method.
- (3) Applied or practical sciences - a discipline that is used to employ existing scientific knowledge to develop more practical applications. Examples include technology or inventions.

- (4) Scientific - a branch of study that is concerned with observation and classification of facts to establish verifiable general laws by using induction and hypotheses.
- (5) Scientific research -
  - a. Conducted in the manner of science or according to results of investigation by science.
  - b. Practicing or using thorough systematic methods.
  - c. Investigating or experimenting to discover and interpret facts, revising accepted theories or laws in the light of new facts, or applying such new or revised theories or laws.
- (6) Scientific Research Organization (SRO) - organizations engaged primarily or exclusively in scientific research. Familiar examples of the scientific activities of Section 501(c)(3) organizations include medical research projects of hospitals and the ongoing research programs of major colleges and universities.

## **E. Law / Authority**

- (1) Section 501(c)(3)
- (2) Treas. Reg. 1.501(c)(3)-1(d)(2)
- (3) Treas. Reg. 1.501(c)(3)-1(d)(5)

## **II. Furthering Scientific Purposes**

### **A. Scientific as an Exempt Purpose**

- (1) Organizations may be described in Section 501(c)(3) if they are organized and operated exclusively for “scientific” purposes.

#### **A.1. Organizational Test**

- (1) The organizational test, as described by Treas. Reg. 1.501(c)(3)-1(b), relates to an entity’s organizing document. Examples include Articles of Incorporation, Charter, Articles of Association, or Trust Document.
- (2) The organizing document must:
  - a. Limit the purpose of the organization to one or more exempt purposes.
  - b. Not empower the organization to engage in activities which are not in furtherance of an exempt purpose.
  - c. Ensure the organization’s net earnings do not inure, in whole or in part, to the benefit of private shareholders or individuals.
  - d. Contain a dissolution clause, where upon ceasing operations, the assets of the organization are transferred to a governmental entity or to a 501(c)(3) organization.



- (3) The organizational test can only be satisfied if the written document, prepared at the time of the organization's formation, meets the requirements of the regulations in both form and language. The organizing document of an entity requesting exemption under Section 501(c)(3) must contain an acceptable purpose clause, prohibition on inurement and political activity, and have an acceptable dissolution clause for net assets to be transferred to another 501(c)(3) organization or to a governmental entity.
- (4) During the determination process, any found deficiencies should be addressed by the EO Determinations' specialist. The organization is required under Revenue Procedure (Rev. Proc.) 2022-5, section 6.08(5), or its successor, to alter its activities or amend its articles prior to receiving its exempt status. Failure to amend the organizational documents should result in a denial of exemption.
- (5) **Note:** Exempt Organizations, Determinations (EOD) has implemented a streamlined process for exemption applications. Under this process, instead of waiting to receive the amended documents, EOD began to accept Counsel-approved attestations from certain organizations under penalties of perjury that the conforming changes have been made. See Rev. Proc. 2022-5 or its successor. This revenue procedure is updated annually.
  - a. For **EO Determinations** cases, see EOD Unit 1A L8, Introduction to IRC 501(c)(3) and the Organizational Test, Organizing Deficiencies and Language for the proper method to correct organizing documents.  
  
Also, see IRM 7.20.2.3, Case Processing, and the streamline processing questions listed on IRS.gov's webpage, Sample Questions - Organizational and Administrative Requirements.
  - b. For **EO Examinations** cases, see IRM 4.75.11.8.1, Governing Instruments, for applicable procedures.

## A.2. Operational Test

- (1) The operational test, as described by Treas. Reg. 1.501(c)(3)-1(c), is specifically related to the exempt purpose and activities of an organization. Even if an organization passes the organizational test by having adequate language regarding its scientific activities, the operational test may indicate that its activities are not strictly scientific or in the public's interest.
- (2) To meet the operational test, the primary activity of the organization must accomplish one or more exempt purposes. Moreover, the organization may not allow earnings to inure to private shareholders or individuals. An organization will be regarded as "operated exclusively" for one or more exempt purposes only if it engages primarily in activities which accomplish one or more of such exempt purposes specified in Section 501(c)(3). Under the operational test, it is the purpose, and not the nature, of the activities which is critical.
- (3) An organization engaged in a single activity, directed toward both exempt and non-exempt purposes, may fail the operational test. This will result in

disallowance of exempt status if any non-exempt purpose is substantial. See Section 501(c)(3) and Treas. Reg. 1.501(c)(3)-1(a)(1).

- (4) The organizational and operational tests are discussed in more detail in TG 3-1 Overview, Applications, Exemption Requirements - Section 501(c)(3).

### A.3. Scientific Purpose

- (1) “Scientific” is not precisely defined in the Code, Regulations, or any published rulings. When a term is not defined in the Code or Regulations, the courts often use generally accepted definitions in a dictionary as a starting place for their analysis of case issues.
- (2) The following judicial decision illustrates how terms and phrases are used throughout the Code that are not defined within the Code itself. The courts have used “general meaning” or referenced a dictionary in defining term(s) material to a legal ruling. Definitions of terms are important when making an assessment or determination. If the Code is silent, we look to the regulations, rulings and case law. If a material term is not defined in administrative tax authority, we may use “general meaning” and define the phrase using a dictionary or other known sources. This example provides the examiner a blueprint on how to address definition of terms in the Revenue Agent Report.
- (3) In *IIT Research Institute v. U.S.*, 9 Cl. Ct. 13 (Cl. Ct. 1985), the U.S. Claims Court’s reasoning and methodology to arrive at an understanding of **science** and **scientific** is stated below:

The terms 'science' and 'scientific' are not defined in the Internal Revenue Code, Congress apparently having chosen to rely on the commonly understood meaning of the term.

- a. The McGraw-Hill Dictionary of Science and Technical Terms, (Lapedes ed., 2d ed., 1978), p. 1414, defines science as a branch of study in which facts are observed, classified, and verified, which involves the application of mathematical reasoning and data analysis to natural phenomenon.
- b. The Random House Dictionary of The English Language, p. 1279 (Stein ed., 1967), defines science as knowledge, as of facts and principles, gained by systematic study.

Thus, in the context of this litigation, 'science' will be defined as the process by which knowledge is systematized or classified using observation, experimentation, or reasoning.

### A.4. Scientific Research

- (1) Treas. Reg. 1.501(c)(3)-1(d)(1)(c) includes **scientific** under Section 501(c)(3) exempt purposes. Treas. Reg. 1.501(c)(3)-1(d)(5)(i) states that for research to be scientific, within the meaning of Section 501(c)(3), it must be carried on in

furtherance of a scientific purpose. The determination of whether research is scientific does not depend on whether such research is fundamental or basic as contrasted with applied or practical.

- (2) The following rulings highlight the concept of scientific research as an exempt purpose:

### **Qualifying Activity**

- a. In Rev. Rul. 71-506, 1971-2 C.B. 233, an engineering society formed to engage in scientific research in the areas of heating, ventilating, and air conditioning for the benefit of the general public was determined to be exempt under Section 501(c)(3). The organization's research was devoted exclusively to the development of data on basic physical phenomena, which data could be used by anyone, and not on the development or improvement of particular products or services.
- b. In Rev. Rul. 65-60, 1965-1 C.B. 231, an organization engaged in research in the social sciences was determined to further educational and scientific purposes. Therefore, it was entitled to exemption under Section 501(c)(3). Scientific organizations are not limited to the study of the hard sciences such as physics or chemistry. They also include the social sciences such as sociology or economics provided such research serves a public interest.

### **Non-Qualifying Activity**

- c. In Rev. Rul. 69-632, 1969-2 C.B. 120, an association, composed of the members of a particular industry, was not exempt under Section 501(c)(3). The association sponsored research projects to develop new and improved uses for the industry's products by selecting research projects to increase sales by creating new uses and markets for their products. Although patents and trademarks resulting from the research were licensed royalty free, the primary beneficiaries of the association's research program were members of the industry.
- (3) Treas. Reg. 1.501(c)(3)-1(d)(5)(ii) distinguishes between scientific research and commercial activities or industrial operations, which are not considered exempt purposes under Section 501(c)(3). Commercial activities may include:
- a. Ordinary testing and/or inspection of materials and products or
  - b. Designing or construction of equipment and buildings and so forth.
- (4) The term 'fundamental research,' as contrasted with 'applied research,' does not include research carried on for the primary purpose of commercial or industrial application. See Treas. Regs. 1.501(c)(3)-1(d)(5)(i) and 1.512(b)-1(f)(4).

## **B. Public Interest**

- (1) Treas. Reg. 1.501(c)(3)-1(d)(5)(i) provides that a scientific organization, as with other organizations described in Section 501(c)(3), must be organized and operated “in the public interest.”

### **B.1. Research in the Public Interest**

- (1) Treas. Reg. 1.501(c)(3)-1(d)(5)(ii) and (iii) stipulates organizations that primarily pursue business purposes or that serve substantial private interests are not entitled to exemption under Section 501(c)(3). Research is regarded as “in the public interest” if all patents or other resulting rights are made “available to the public.”
- (2) However, Treas. Reg. 1.501(c)(3)-1(d)(5)(iii) provides that research will “be carried on in the public interest” even though the sponsor obtains patents or other resulting rights if:
  - a. The research results are published.
  - b. The research is done for the United States, an instrumentality, or a local government, or
  - c. The research is directed toward benefiting the public in some other way, such as to further the education of university students, to develop data for publication, to cure a disease, or to bring new industry to a community.
- (3) In Rev. Rul. 65-60, 1965-1 C.B. 231 an organization carrying on research and publicly disseminating knowledge in the field of the social sciences was held to be educational and scientific under Section 501(c)(3).

### **B.2. Examples of Public Interest**

- (1) The following are examples of scientific research benefiting the public, as expressed in Treas. Reg. 1.501(c)(3)-1(d)(5)(iii)(c), for the purpose of:
  - a. Aiding in the scientific education of college or university students
  - b. Obtaining scientific information, which is published in a treatise, thesis, trade publication, or in any other form that is available to the interested public
  - c. Discovering a cure for a disease, or
  - d. Aiding a community or geographical area by attracting new industry to the community or area or by encouraging the development of, or retention of, an industry in the community or area.
- (2) Scientific research described as aiding the community will be regarded as carried on in the public interest even though such research is performed pursuant to a contract or agreement under which the sponsor(s) of the research have the right to obtain ownership or control of any patents, copyrights, processes, or formulae resulting from such research. See Treas. Reg. 1.501(c)(3)-1(d)(5)(iii).

- (3) If a patent, copyright, process, or formula is made available to the public on a nondiscriminatory basis it shall be considered made available to the public.
- (4) In addition, although one person is granted the exclusive right to the use of a patent, copyright, process, or formula, such patent, copyright, process, or formula shall be considered as made available to the public if the granting of such exclusive right is the only practicable manner in which the patent, copyright, process, or formula can be utilized to benefit the public. See Treas. Reg. 1.501(c)(3)-1(d)(5)(vi)(b).
- (5) Rev. Rul. 76-296, 1976-2 C.B. 142 is the controlling authority on this subject. The revenue ruling considers the publication requirement as well as the commercial sponsor's right to exploit the results of the research findings. It was published to provide a clear example of how issues involving commercially sponsored scientific research projects should be treated.

The ruling provides two scenarios:

**a. Qualifying Activity**

First scenario is where publication by the tax-exempt scientific research organization was made available to the interested public in a timely manner even though the organization allowed a lapse of a reasonable time in order to afford the sponsor an opportunity to establish patent rights or other ownership rights. This is an exempt activity because it is considered to be in the public interest.

**b. Non-Qualifying Activity**

Second scenario is where a tax-exempt organization withholds or significantly delays publication of its findings beyond the time reasonably necessary to establish patent or other ownership rights in the results of the research in order to accommodate the sponsor's business interest in maintaining the secrecy of certain results or to control the timing of public disclosure of the results. This scenario fails the publication test. The research connected with such projects, therefore, is not scientific research carried on in the public interest within the meaning of section 501(c)(3) of the Code. Consequently, the income derived from the project is unrelated business income.

- (6) In *Quality Auditing Co. v. Commissioner*, 114 T.C. 498 (2000) the court upheld a revocation of an organization that administered a structural steel fabricators certification program with another exempt organization. The court found the corporation was operated to benefit private interests of the steel industry.

## **C. Advancement of Science**

- (1) The advancement of science is a charitable purpose within the meaning of Section 501(c)(3). The purpose of advancing science is generally fulfilled not by

the direct conduct of scientific research but rather by the support of organizations that engage in research.

- (2) Under Treas. Reg. 1.501(c)(3)-1(d)(2) an organization may fulfil its charitable exempt purpose by advancing science and need not conduct scientific activities directly. For example, an organization that makes grants to universities for scientific research is regarded as advancing science.
- (3) In Rev. Rul. 66-147, 1966-1 C.B. 137, an organization engaged in surveying scientific and medical literature and abstracting and publishing it free of charge was found to be exempt because it was engaged in the advancement of education or science.

### C.1. Promotion of Scientific Research

- (1) An organization may also qualify for exemption under Section 501(c)(3) as an organization "promoting" scientific research.

- (2) **Qualifying Activity**

In *Science and Research Foundation, Inc. v. United States*, 181 F. Supp. 526 (S.D. Ill. 1960) the court recognized that research is not the only activity that can be scientific. The court determined that the publication of scientific booklets was an exempt activity under Section 501(c)(3) by promoting science and education and was not a commercial activity.

- (3) **Non-Qualifying Activity**

In *Washington Research Foundation v. Commissioner*, T.C. Memo 1985-570, (1985), an organization argued that its activities furthered scientific purposes even though it was not itself engaged in scientific research. The court concluded that the organization's activities were not scientific nor were they advancing scientific research. While acknowledging that some activities advanced education, the court found an overriding commercial purpose in denying exemption under Section 501(c)(3).

### D. Scientific Research

- (1) Research, when taken alone, is a word with various meanings. It is not synonymous with scientific. The nature of particular research depends upon the purpose which it serves. The regulations do not draw any fine distinctions among the types of information gathering that might be regarded as research.
- (2) To determine if an activity is **scientific research** under Section 501(c)(3) review published authority, such as revenue rulings, for situations similar to your case. If the activities are unique and such authority is absent, one must take a facts and circumstances approach in determining if such activity meets the requirements of Treas. Reg. 1.501(c)(3)-1(d).

## D.1. Scientific Research Defined

- (1) Treas. Reg. 1.501(c)(3)-1(d)(5) is the principal authority for resolving exemption questions and "relatedness" questions under the unrelated business income tax provisions. The term "scientific," as used in Section 501(c)(3), includes scientific research in the public interest. Scientific organizations generally engage in some form of "research." However, not all research is "scientific" and not all scientific research is carried on in the public interest.
- (2) Treas. Reg. 1.501(c)(3)-1(d)(5)(i) states, "since an organization may meet the requirements of Section 501(c)(3) only if it serves a public rather than a private interest, a scientific organization must be organized and operated in the public interest."
- (3) The determination as to whether research is scientific does not depend on whether such research is classified as fundamental or basic as contrasted with applied or practical.
  - a. Fundamental or basic science are methods used to develop information to explain phenomena in the natural world. Examples include chemistry, physics, and earth science.
  - b. Applied or practical sciences is a discipline that is used to employ existing scientific knowledge to develop more practical applications. Examples include technology or inventions.

On the other hand, for purposes of the exclusion from unrelated business taxable income provided by Section 512(b)(9), it is necessary to determine whether the organization is operated primarily for purposes of carrying on fundamental, as contrasted with applied, research.

- (4) Scientific research does not include activities ordinarily carried on as part of commercial or industrial operations.

For example, the following aren't exempt activities:

- a. Ordinary testing or inspection of materials or products.
- b. Designing or construction of equipment, buildings.

See Treas. Reg. 1.501(c)(3)-1(d)(5)(ii).

- (5) An organization, including a college, university, or hospital, carrying on research which is not in furtherance of an exempt purpose described in Section 501(c)(3) is not precluded from exemption under Section 501(c)(3) so long as:
  - a. The organization meets the organizational test, and
  - b. Is not operated for the primary purpose of carrying on such research.

## D.2. Three-Part Test

- (1) To determine if scientific research is compatible with the provisions of Section 501(c)(3), a three-part test is promulgated under Treas. Reg. 1.501(c)(3)-

1(d)(5). This formulation can be broken down into its constituent parts to form three questions concerning the organization's activities:

- a. Is it scientific?
- b. Is it research?
- c. Is it in the public interest?

(2) Unless the non-exempt activity is the primary activity of the organization, the non-exempt activity doesn't jeopardize the tax-exempt status of the 501(c)(3) organization. However, the organization may be subject to unrelated business income tax (UBIT).

**(3) Is it Scientific?**

To determine whether research is "scientific" for purposes of Section 501(c)(3) does not depend on whether such research is classified as "fundamental" or "basic" as contrasted with "applied" or "practical". Therefore, for purposes of Section 501(c)(3), debates about "pure" science serve no useful purposes.

- a. In *Midwest Research. Inst. v. United States*, 744 F.2d 635 (8th Cir. 1984) the Court held, "if professional skill is involved in the design and supervision of a project intended to solve a problem through a search for a demonstrable truth, the project would appear to be scientific research."
- b. Another common distinction which is precluded is the one between the "hard" sciences, such as physics or chemistry, and the social sciences, such as sociology or economics. Rev. Rul. 65-60, 1965-1 C.B. 231, holds that an organization engaged in research in the social sciences was furthering educational and scientific purposes and was, therefore, entitled to exemption under Section 501(c)(3).

**(4) Is it Research?**

The following rulings highlight generally the concept of scientific research as an exempt purpose:

- a. In Rev. Rul. 69-632, 1969-2 C.B. 120 an association composed of the members of a particular industry was not exempt under Section 501(c)(3). The association sponsored research projects to develop new and improved uses for the industry's products. Although patents and trademarks resulting from the research were licensed royalty free, the primary beneficiaries of the association's research program were members of the industry.
- b. In Rev. Rul. 71-506, 1971-2 C.B. 233 an engineering society formed to engage in scientific research in the areas of heating, ventilating, and air conditioning for the benefit of the general public was determined to be exempt under Section 501(c)(3). The organization's research was devoted exclusively to the development of data on basic physical phenomena,



which data could be used by anyone, and not on the development or improvement of particular products or services.

- c. In Rev. Rul. 69-632, 1969-2 C.B. 120 an organization composed of members of an industry to develop new and improved uses for products of the industry was not an exempt scientific organization under Section 501(c)(3). The ruling determined that the organization was primarily serving the private interests of its creators, rather than the public interest.
- d. In Rev. Rul. 69-526, 1969-2 C.B. 115 an organization formed by a group of physicians specializing in heart disease to research the cause and to publish treatments of heart defects qualifies for Section 501(c)(3) exemption. The ruling found that any personal benefit (in the form of increased prestige and enhanced reputation) derived by the physician-creators did not lessen the public benefits from the organization's operations and is not considered to be the type of private interest referred to in Section 1.501(c)(3)-1(d)(5)(i) of the Regulations.

#### **(5) Is it In the Public's Interest?**

- a. Treas. Reg. 1.501(c)(3)-1(d)(5)(iii) stipulates, scientific research will be regarded as carried on in the public interest, if either:
  - Results are publicly available on a nondiscriminatory basis.
  - Performed for the United States, or
  - Directed toward benefiting the public.
- b. Examples of research in the public's interest that are provided within the regulation are:
  - Aiding scientific education of college students,
  - Obtaining scientific information to make publicly available through publication of findings,
  - Discovering cures for diseases, and
  - Aiding a community by attracting industry to the area.

### **D.3. Research Performed Under Contract**

- (1) Research that benefits the public within the meaning of Treas. Reg. 1.501(c)(3)-1(d)(5)(iii)(c), will be regarded as carried on in the public interest, even though such research is performed pursuant to a contract or agreement under which the sponsor or sponsors of the research have the right to obtain ownership or control of any patents, copyrights, processes, or formulae resulting from such research.
- (2) Commercially sponsored research that otherwise qualifies as scientific research under Section 501(c)(3) constitutes scientific research carried on in the public interest if the results, including all relevant information, are:

- a. Timely published in a form available to the interested public
  - b. Even though it is performed pursuant to a contract under which the sponsor has the right to obtain ownership of the patent.
- (3) Rev. Rul. 76-296, 1976-2 C.B. 141, distinguishes two situations involving scientific research undertaken pursuant to contracts with private industry:

a. **Qualifying Activity**

Commercially sponsored research that otherwise qualifies as scientific research under Section 501(c)(3) constitutes scientific research carried on in the public interest if the results, including all relevant information, are timely published in a form available to the interested public, even though it is performed pursuant to a contract under which the sponsor has the right to obtain ownership of the patent.

b. **Non-Qualifying Activity**

Research is not in the public interest and constitutes unrelated trade or business within the meaning of Section 513 if publication is withheld or delayed significantly beyond the time reasonably necessary to establish ownership rights. That is, the organization agreed, upon request, to forego or significantly delay publication of results of a particular project to protect the sponsor's processes, technical data, or patent rights.

#### **D.4. Medical Research Organization**

- (1) Sections 509(a)(1) and 170(b)(1)(A)(iii) states an organization is a public charity if, "the principal purpose or functions of which are the providing of medical or hospital care or medical education or medical research, if the organization is a hospital, or if the organization is a medical research organization directly engaged in the continuous active conduct of medical research in conjunction with a hospital."
- (2) General Counsel Memorandum, GCM 34128 (1969), concluded a nonprofit organization established for the purpose of conducting scientific research in a field of medicine which is the specialty of its physician-creators may be exempt from federal income tax under section 501(c)(3) provided its research serves a public purpose and no part of its net earnings inures to any private shareholder or individual.
- (3) Rev. Rul. 69-526, 1969-2 C.B. 115 describes an organization was formed and operated for the purpose of conducting scientific research into cardiovascular diseases. Patients were referred for the study, without regard to ability to pay. Results of the study created new methods and procedures for preventing and treating heart defects. The results and procedures derived are made public through publication in scientific journals. It's held by conducting the research program in the manner described and by making the results publicly available the organization is operated for scientific purposes within the meaning of section 501(c)(3).

- (4) Any personal benefit derived by the creators does not lessen the public benefits and is not private interest under Treas. Reg. 1.501(c)(3)-1(d)(5)(i).

## **D.5. Agricultural Research Organization**

- (1) Sections 501(a)(1) and 170(b)(1)(A)(ix), describes a tax-exempt agricultural research organization, as a public charity if it is directly engaged in the continuous and active conduct of agricultural research in conjunction with a land-grant college or university or a non-land grant college of agriculture.
- (2) Land-grant Institutions are colleges and universities designated to receive benefits of the Morrill Acts of 1862 and 1890. These acts promoted establishment of institutions of higher learning focused on the agricultural and mechanical arts, without excluding other scientific and classical studies. Land-grant institutions now address many academic fields in addition to those of their foundational colleges of agriculture. There is at least one land-grant institution in each U.S. state, the District of Columbia, the Federated States of Micronesia, and many U.S. territories.
- (3) Federal legislation established three functional pillars of land-grant institutions:
  - a. Teaching
  - b. Research
  - c. Agricultural extension

First among them is the teaching function established through the Morrill Acts of 1862 and 1890. Later legislation added research and extension, establishing the roles of land-grant institutions in producing original agricultural research and in bringing that research to the non-university public through agricultural extension.

- (4) Land-grant colleges include some of the nation's largest and well-known universities, including:
  - a. Cornell University
  - b. University of Illinois,
  - c. Pennsylvania State University
  - d. Auburn University, and
  - e. University of California system.
- (5) Land-grant colleges also include:
  - a. Agricultural and Mechanical colleges such as, Texas A&M
  - b. Historically black colleges and universities (HBCU), such as, Southern University and North Carolina A&T
  - c. Tribal colleges and universities (TCU), for example, Leach Lake Tribal College in Cass Lake, Minnesota.

- (6) Non-land grant institutions - Additional institutional categories are recognized for specific programs. These categories include non-land-grant colleges of agriculture (NLGCAs), Hispanic-serving agricultural colleges and universities (HSACUs), and cooperating forestry schools. See CRS Report, U.S. Land-Grant Universities Systems: An Overview, at Congressional Research Services. <https://crsreports.congress.gov>.
- (7) Other Agricultural Organizations - *Indiana Crop Improvement Ass'n, Inc. v. Comm'r of Internal Revenue*, 76 T.C. 394 (1981), acq., IRS Announcement WL 383622 Relating to: *Indiana Crop Improvement Assn., Inc. (IRS ACQ 1981)* held that an organization whose primary activity consists of the certification of crop seed within the State of Indiana, conducting scientific research in seed technology and providing instruction in modern seed technology in conjunction with Purdue University is exempt under Section 501(c)(3).

(8) **Non-Qualifying Activities**

Private Letter Ruling (PLR) 202105011 describes a denial of exemption of a medical marijuana dispensary under Section 501(c)(3) and 170(b)(1)(A)(ix). The denial is due in part to the fact that marijuana is listed as a Type I controlled substance under the Controlled Substances Act, and the organization failed to provide evidence of working with or being associated with a college or university for research purposes. The Controlled Substances Act holds that a schedule I substance is a narcotic that:

- a. Has a high potential for abuse.
- b. Has no currently accepted medical use in treatment in the United States.
- c. Where there is a lack of accepted safety for use of the drug under medical supervision.

## **D.6. Examples of Scientific Research Organizations**

- (1) Examples of scientific research benefiting the public are:
  - a. Scientific research carried on for the purpose of aiding in the scientific education of college or university students.
  - b. Scientific research carried on for the purpose of obtaining scientific information, which is published in a treatise, thesis, trade publication, or in any other form, which is available to the interested public.
  - c. Scientific research carried on for the purpose of discovering a cure for a disease.
  - d. Scientific research carried on for the purpose of aiding a community or geographical area by attracting new industry to the community or area or by encouraging the development of, or retention of, an industry in the community or area.
- (2) Scientific research will be regarded as carried on in the public interest even though such research is performed pursuant to a contract or agreement under

which the sponsor or sponsors of the research have the right to obtain ownership or control of any patents, copyrights, processes, or formulae resulting from such research.

## **E. Scientific Research Conducted for Nonexempt Purposes**

- (1) Scientific research will be considered to be for nonexempt purposes if it's primarily conducted for the benefit of the organization's creators or is commercial in nature.

### **E.1. Research Conducted for the Organization's Creators**

- (1) Treas. Reg. 1.501(c)(3)-1(d)(5)(iv) states, for purposes of this subsection, that an organization will not be regarded as organized and operated for the purpose of carrying on scientific research in the public interest if:
  - a. The organization will perform research only for the creators of the organization whether directly or indirectly, or
  - b. The organization retains the ownership or control, whether directly or indirectly, of more than an insubstantial portion of the patents, copyrights, processes, or formulae resulting from its research and does not make them available to the public on a nondiscriminatory basis.
- (2) Rev. Rul. 69-632, 1969-2 C.B. 120, is a situation involving Treas. Reg. 1.501(c)(3)-1(d)(5)(iv), along with other sections of the regulations.
  - a. An association was formed by members of a particular industry to develop new and improved uses for existing products.
  - b. The organization entered into research contracts for which the results were timely published to be available to the interested public.
  - c. The organization's members selected research projects in order to increase their sales by creating new uses and markets for their products.

This revenue ruling holds that the organization served the private interests of its creators and, therefore, it was not entitled to exemption under IRC 501(c)(3).

However, because no services were performed for individual members and the activities of the organization were directed to improving conditions in the industry as a whole, the organization was held to be entitled to exemption under IRC 501(c)(6), as a business league.

- (3) In *David Muresan Science Research Found. v. Commissioner*, 115 T.C.M. 1047, the court held that the organization did not meet the requirements of Section 501(c)(3) or Treas. Reg. 1.501(c)(3)-1(d)(1)(ii) because the organization operates for the benefit of private interests, such as designated individuals or the creator of the organization.

## E.2. Research Incidental to Commercial Operations

### (1) Non-Qualifying Activities

Scientific research does not include activities of a type ordinarily carried on as an incident to commercial or industrial operations such as the inspection of products or the designing of equipment. The following regulations and rulings illustrate this distinction:

- a. Clinical testing of drugs for pharmaceutical companies is not scientific research under Treas. Reg. 1.501(c)(3)-1(d)(5)(ii).
  - b. Rev. Rul. 68-373, 1968-2 C.B. 206 indicates that clinical testing is an activity incidental to a pharmaceutical company's commercial operations and fails to qualify for exemption under Section 501(c)(3).
  - c. Rev. Rul. 65-1, 1965-1 C.B. 226 provides that an organization promoting the development and design of new machinery for a particular commercial operation and that had the power to sell, assign, or license the resulting patent rights didn't qualify for exemption. Its activities were determined not to be scientific research and incidental to a commercial operation.
- (2) The standards set forth in Revenue Rulings 65-1 and 68-373 are most useful in a manufacturing context and have limited utility when applied to commercially sponsored research projects funded by private high technology enterprises such as, firms engaged in producing advanced biomedical equipment.
- a. An example of "ordinary commercial activity" may include scientific research projects and the design and testing of experimental prototypes of new equipment.
  - b. Instead of conducting the research or experimental testing itself, the sponsoring biomedical firm may contract for these tasks to be performed by an SRO. Such tasks will be considered commercial testing activity and is not considered to be scientific research.
- (3) The following rulings found that testing and research activities similar to commercial or industrial operations did not constitute scientific research within the meaning of the regulations and were not exempt activities under Section 501(c)(3).
- a. Rev. Rul. 78-426, 1978-2 C.B. 175, describes an organization that inspects, tests, and certifies cargo shipping containers for safety; as well as performs research, development, and reporting of information in the field of containerization.
  - b. In *American Kennel Club, Inc. v. Hoey, Exrx.*, 148 F.2d 920 (2nd Cir. 1945), the court held that the AKC is not an exempt scientific organization, as the organization's primary function is not scientific, even though one of its activities is the compilation of data useful to geneticists and other scientists.

#### (4) **Qualifying Activity**

In *Dumaine Farms v. Commissioner*, 73.T.C. 650 (1980), the Tax Court held an experimental demonstration farm is exempt under Section 501(c)(3). The court found that the programs provided a broad public benefit and did not resemble commercial farming. Further, they held that the Trust, known as Dumaine Farms was operated for scientific purposes within the meaning of Section 501(c)(3).

### **III. Adverse Factors**

- (1) This section discusses adverse issues that may result in revocation of exempt status and/or tax assessment. These adverse factors include inurement and private benefit.

#### **A. Inurement and Private Benefit**

- (1) Section 501(c)(3) provides, in part, for the exemption from Federal income tax for organizations organized and operated exclusively for charitable, religious, or educational purposes, no part of the net earnings of which inures to the benefit of any private shareholder or individual.
- (2) Treas. Reg. 1.501(c)(3)-1(c)(2) states an organization is not operated exclusively for the statutory purposes if its net earnings inure to the benefit of individuals.
- (3) Treas. Reg. 1.501(c)(3)-1(d)(1)(ii) states that an organization is not operated exclusively for one or more exempt purposes unless it serves a public rather than a private interest. It must not be operated for the benefit of designated individuals or the persons who created it.
- (4) Treas. Reg. 1.501(a)-1(c) states the “words private shareholder or individual” in Section 501 refer to persons that have a personal and private interest in the activities of the organization. Under Section 4958, such private shareholder or individual is regarded as a disqualified person.
- (5) The terms inurement and private benefit are not interchangeable. Private benefit is broader than inurement. All inurement is private benefit but not all private benefit is inurement. Any amount of inurement can endanger an organization’s exemption. However, the organization’s exemption will not be endangered if private benefit is insubstantial and incidental. Inurement is limited to insiders only. Private benefit is not limited to insiders.

#### **A.1. Inurement**

- (1) Inurement can be viewed as an insider benefit, with the term “insider” providing a distinction from the broader concept of private benefit. Inurement occurs where an exempt organization engages in a transaction with an insider and there is a purpose to benefit the insider rather than the organization; even though the transaction may ultimately be profitable to the exempt organization. The test is not ultimately profit or loss but whether, at every stage of the

transaction, those controlling the organization guarded its interests and dealt with related parties at arms-length.

- (2) The use of the term “benefit” highlights the broad interpretation placed on the Code language of “net earnings.” The “net earnings” reference goes beyond a narrow accounting definition of net income to encompass almost any use, other than in an arm’s-length transaction or as reasonable compensation, made of an organization’s assets by an insider.
- (3) In *Leon A. Beeghly Fund v. Commissioner*, 35 T.C. 490 (1960), inurement occurred when the organization entered into a transaction to benefit the stockholders of a business corporation, not to benefit the charity, even though the charity suffered no financial loss.
- (4) **Examples of Inurement** may include the following
  - a. Unreasonable compensation
  - b. Payment of excess rent
  - c. Reversion or retained interest
  - d. Receipt of less than fair market value for assets
  - e. Inadequately secured loans

## A.2. Private Benefit

- (1) As previously noted, to be charitable, an organization must serve a public rather than a private interest. The organization must demonstrate that it is not organized or operated for the benefit of private interests such as designated individuals, the creator or his family, shareholders of the organization, or persons controlled directly or indirectly by such private interests.
- (2) The private benefit restriction is not limited to benefits provided to insiders. Rather, the restriction applies to benefits provided to any individual, whether or not the individual is in a position to control or influence the organization. The private benefit restriction applies to all parties who receive a benefit not accorded to the public as a whole.
- (3) Private benefit will not jeopardize tax-exempt status if it is incidental to the accomplishment of exempt purposes. However, an activity that primarily serves private interests may jeopardize exempt status if it is carried on to a degree that is more than an insubstantial part of the organization’s activities.
- (4) In *Columbia Park & Recreation Ass'n, Inc. v. Comm'r*, 838 F.2d 465 (4th Cir. 1988) the court upheld denial of exemption under Section 501(c)(3) to an organization formed to develop and operate utilities, systems, services, and facilities “for the common good and social welfare” for a private real estate development with a population of over 100,000 residents. The development was neither an incorporated city nor other form of political subdivision. The court considered this fact significant in concluding that the organization was “...merely an aggregation of homeowners and tenants bound together in a



structural unit formed as an integral part of a plan for the development of real estate.” As such, it lacked a “sufficient public element” to be a “community at large” in the charitable context.

- (5) Rev. Rul. 65-1, 1965-1 C.B. 226 discusses an organization that promotes the development and design of farm machinery. The operations of the organization, including the development of machinery and the restricted licensed patents to selected manufacturers, provides a private benefit and any public benefit is indirect. The organization failed to qualify for exemption under IRC section 501(c)(3).

### **A.3. Private Interest Incidental to Exempt Purpose**

- (1) If an organization serves a public interest and also serves a private interest greater than incidentally, it is not entitled to exemption under Section 501(c)(3). The key to understanding the concept of private benefit is understanding what “incidental” means in both a quantitative and a qualitative sense.
- (2) A private benefit would be considered to be qualitatively incidental if:
  - a. The benefit to the public cannot be achieved without necessarily benefitting certain private individuals, and
  - b. The private benefit is not substantial relative to the public benefit.
- (3) A facts and circumstances test is required to determine if public benefit from the organization’s activities outweighs any individual benefit.

### **B. Section 4958 Excise Taxes, Intermediate Sanctions**

- (1) Section 4958 imposes an excise tax on a disqualified person who engages in an excess benefit transaction with an applicable tax-exempt organization. Before Section 4958 was enacted, revocation of exempt status was the only sanction available when a disqualified person received an excess benefit from a transaction with an applicable tax-exempt organization.
- (2) Section 4958 created an excise tax intermediate sanction that can be imposed on the disqualified person and the organization manager who knowingly participated in the transaction. The excise tax is never imposed on the organization, itself.
- (3) An excess benefit transaction is any transaction in which:
  - a. An excess benefit is provided by the organization, directly or indirectly to, or for the use of, any disqualified person, or
  - b. The amount of any economic benefit provided to, or for the use of, a disqualified person is determined in whole or in part by the revenues of the organization and violates the private inurement prohibition rules.

## **B.1. Tier I Tax**

- (1) The “intermediate sanctions” provisions imposes on each excess benefit transaction an initial tax equal to 25% of the excess benefit derived and shall be paid by each disqualified person benefiting from the prohibited transactions.
- (2) In any case in which a tax has been imposed for an excess benefit transaction, a tax equal to 10 %of the excess benefit amount is imposed up to a maximum amount of \$20,000 and shall be paid by each organization manager who participated in the prohibited transactions unless such participation is not willful and is duet to reasonable cause. If more than one person is liable for any tax imposed by Section 4958(a) or (b), all such persons shall be jointly and severally liable for such tax.

## **B.2. Tier II Tax**

- (1) In any case in which an initial tax Section 4958(a) is imposed on a disqualified person for an excess benefit transaction and the amount of the excess benefit involved in such transaction is not corrected within the allowable taxable period, Section 4958(b) imposes an additional tax equal to 200 % of the excess benefit amount involved in the prohibited transactions.
- (2) The additional tax imposed will be paid by each disqualified person with respect to such transactions.

## **B.3. Definitions of Terms**

- (1) Excess benefit transaction – any transaction in which an economic benefit is provided by an organization directly or indirectly to or for the use of any disqualified person if the value of the economic benefit provided exceeds the value of the consideration (including the performance of services) received for providing such benefit. See Section 4958(c)(1)(A).
- (2) Disqualified person – any person who is able to exercise substantial influence over the affairs of the organization. It includes family members of such an individual or a 35 percent controlled entity. See Section 4958(f)(1).
- (3) Taxable period, with respect to any excess benefit transaction, is the period beginning with the date on which the transaction occurs and ending on the earliest of the date of mailing a notice of deficiency under Section 6212 with respect to the initial tax imposed by Section 4958(a)(1), or the date on which the initial tax is assessed. See Section 4958(f)(5).
- (4) For an in-depth discussion of taxes on excess benefit transactions see the following Technical Guides:
  - a. TG 3-8: Disqualifying and Non-Exempt Activities, Inurement and Private Benefit - IRC 501(c)(3)
  - b. TG 65, Excess Benefit Transactions, IRC 4958

## **IV. Unrelated Business Income (UBI)**

### **A. Unrelated Business Activities**

- (1) Unrelated business issues generally come into play when a scientific research organization has established its exempt status and is actively engaged in a variety of scientific research projects.
- (2) If scientific research projects produce income, Sections 511, 512 and 513 must be considered. Treas. Reg. 1.513-1(a) defines the term "unrelated business taxable income" as the gross income derived from any trade or business regularly carried on by an exempt organization which is not substantially related, aside from the need of the organization for funds, to the exercise of the organization's exempt function.
- (3) IRC 512(b)(9) provides that, in the case of an organization operated primarily for purposes of carrying on fundamental research the results of which are freely available to the general public, all income derived from research performed for any person, and all deductions directly connected with such income, shall be excluded in computing unrelated business taxable income. The term 'fundamental research,' as contrasted with 'applied research,' does not include research carried on for the primary purpose of commercial or industrial application. See Treas. Regs. 1.501(c)(3)-1(d)(5)(i) and 1.512(b)-1(f)(4). See *Midwest Research. Inst. v. United States*, 554 F. Supp. 1379 (W.D. Mo. 1983), *aff'd*, 744 F.2d 635 (8th Cir. 1984)
- (4) For additional information on this topic, see
  - a. Technical Guide 3-10, Disqualifying and Non-Exempt Activities, Trade or Business Activities, IRC 501(c)(3)
  - b. Technical Guide 48, Unrelated Business Income Tax

#### **A.1. Siloing UBI Activities**

- (1) Section 512(a)(6) enacted under the Tax Cut and Jobs Act of 2017, imposes a new requirement for organizations that regularly carry on multiple unrelated business activities.
- (2) For tax years beginning after December 31, 2017, an organization that regularly carries on two or more unrelated business activities, must separately compute its unrelated business taxable income with respect to each unrelated trade or business, including for purposes of determining any net operating loss deduction. This practice is often referred to as "siloing."
- (3) The organization's total unrelated business taxable income is the sum of each component of unrelated business taxable income, computed separately with respect to each such trade or business, less the specific deduction under Section 512(b)(12).

- (4) For purposes of calculating total unrelated business taxable income, the unrelated business taxable income with respect to any trade or business is not less than zero.

## **A.2. Notice 2018-67, Safe Harbor**

- (1) Notice 2018-67 provides a safe harbor for organizations reporting unrelated business income for tax years beginning after 2017 and before December 2, 2020 to report multiple unrelated business activities prior to the publishing of final regulations and creation of new forms.
- (2) The safe harbor states, “an exempt organization may rely on a reasonable, good-faith interpretation of Sections 511 through 514 (considering all the facts and circumstances), the proposed regulations in their entirety, or the methods provided in Notice 2018-67 to identify separate unrelated trades or businesses for purposes of Section 512(a)(6)(A). A reasonable, good-faith interpretation includes using the North American Industry Classification System (NAICS) 6-digit codes described in section 3.03 of the notice.”
- (3) See Notice 2018-67 for a full discussion on:
  - a. Implementation of Section 512(a)(6)
  - b. Desire to develop a more administrable method than a facts and circumstances test alone for identifying separate trades or businesses
  - c. Allocation of indirect expenses, and
  - d. Request for public comments

## **B. Identifying Unrelated Business Income Activities**

- (1) To determine if an activity is unrelated business income, the following questions must be answered in the affirmative:
  - a. Is the activity unrelated to the attainment of the organization's exempt purpose?
  - b. Is it trade or business?
  - c. Is it regularly carried on?

### **B.1. Relatedness**

- (1) With respect to Section 501(c)(3) organizations, Treas. Reg. 1.501(c)(3)-1(d)(5) is generally helpful in considering "relatedness" questions when the organization is an SRO.
- (2) A trade or business is "related" to exempt purposes only if the conduct of the trade or business manifests a causal and fundamental relationship to the achievement of the organization's exempt purposes, other than simply through the production of income.

- (3) For a trade or business to be "substantially related" to exempt purposes, the production, distribution of goods and/or performance of services from which the gross income is derived must contribute importantly to the accomplishment of the organization's exempt purposes.
- (4) In Rev. Rul. 76-296, 1976-2 C.B. 141 the term 'unrelated trade or business' is defined in Section 513 to mean, in the case of any organization subject to the tax imposed by Section 511, any trade or business the conduct of which is not substantially related (aside from the need of such organization for income or funds or the use it makes of the profits derived) to the exercise or performance by such organization of its exempt purposes or functions.
- (5) Whether activities productive of gross income contribute importantly to the accomplishment of any purpose for which an organization is granted exemption depends in each case upon the facts and circumstances involved. See Treas. Reg. 1.513-1(d)(2).
- (6) If the exempt organization is not an SRO the "relatedness" question must be decided on the basis of the particular organization's exempt purpose and whether the particular research activity is substantially related to that exempt purpose.

## **B.2. Trade or Business**

- (1) Similarly, questions as to whether a particular activity is trade or business and whether it is regularly carried on have to be resolved on the basis of authorities and precedents specifically applicable to those issues.
- (2) Treas. Reg. 1.513-1(b) affords that for purposes of Section 513, "trade or business" has the same meaning as it has in Section 162. It generally includes any activity carried on for the production of income via the sale of goods or performance of services.
- (3) The term "trade or business" in Section 513 is not limited to integrated aggregates of assets, activities, and goodwill which comprise businesses for the purposes of certain other provisions of the IRC. Activities of producing or distributing goods or performing services from which a particular amount of gross income is derived do not lose their identity as a trade or business merely because they are carried on within a larger complex of other endeavors which may (or may not) be related to the exempt purposes of the organization.
- (4) Where an activity carried on for the production of income constitutes an unrelated trade or business, no part of such trade or business shall be excluded from such classification merely because it does not result in a profit.

## **B.3. Regularly Carried On**

- (1) Treas. Reg. 1.513-1(c)(1) provides that to determine whether a trade or business from which a particular amount of gross income derives is "regularly carried on," the examiner must consider the frequency and continuity with which

the activities producing the income are conducted and the manner in which they are pursued.

- (2) Ordinarily, specific business activities of an exempt organization are considered "regularly carried on" if they manifest a frequency and continuity, and are pursued in a manner, generally similar to comparable commercial activities of nonexempt organizations.
- (3) The purpose of unrelated business income tax is to place exempt organization business activities on the same tax basis as competing nonexempt business endeavors. So that organizations exempt from federal taxation do not receive an unfair advantage when openly competing with taxable entities.
- (4) Scientific research does not include activities of a type ordinarily carried on as an incident to commercial or industrial operations such as the inspection of products or the designing of equipment. See Treas. Reg. 1.512(b)(1)(f)(4).

## **C. Modifications to Unrelated Business Taxable Income**

- (1) Even when there is an unrelated trade or business activity regularly carried on, the income from such activity still may not be subject to tax because many kinds of income are excluded from tax by exceptions and exclusions contained in Section 512(b).
- (2) Royalties, research for governmental entities, and research by universities, colleges, and hospitals are excluded from taxation under Section 512(b)(2).

### **C.1. Royalties**

- (1) Section 512(b)(2) excludes from the calculation of unrelated business taxable income all royalties (including overriding royalties), whether measured by gross or taxable income from the property and all deductions directly connected with such income.
- (2) Royalties are payments that buy the right to use someone else's property. Payments for the use of patents, trademarks, and so forth, are ordinarily classified as royalties.
- (3) The exclusion of royalties on patents retained by a Section 501(c)(3) organization assumes that the retention and licensing of the patents does not result in loss of exempt status under Treas. Reg. 1.501(c)(3)-1(d)(5)(iv) which specifically discusses ways that an organization will not be organized or operated for scientific research in the public interest.

### **C.2. Example of a Royalty Exception**

- (1) Technical Advice Memorandum (TAM) 8028004 provides a typical example of the way the royalty exception works in actual practice.
- (2) The TAM explained that M, the exempt SRO, had particular expertise in the field of advanced medical diagnostic equipment. Pursuant to a contractual understanding with S, a commercial enterprise, M developed an add-on device

for use with S's already existing diagnostic machine which was then available on the commercial market. The results of the project were never published. In exchange for doing the research and development work for S, M received the right to a five percent royalty on net sales of the add-on unit. The activity of developing the add-on unit was found not to be scientific research in the public interest because the results were never published, and the work done was ordinary testing incident to the expansion of S's existing product line.

- (3) The National Office concluded that the research project was unrelated trade or business. However, the five percent share of net sales of the add-on unit produced no tax consequences for M because the income was excluded from the computation of unrelated business tax as a royalty by IRC 512(b)(2).

### **C.3. Research for Governmental Entities**

- (1) The statutory sections providing for the exclusion of income derived from research for governmental entities, and so forth, have corollary provisions in the regulations, which are grouped together under the heading "Research" in Treas. Reg. 1.512(b)-1(f).
  - a. Subparagraph (1) of the regulation deals with the exclusion for income from research performed for the United States or any of its agencies or instrumentalities or a State or political subdivision of a State.
  - b. Subparagraph (2) excludes the income of a college, university, or hospital from research performed for any person.
  - c. Subparagraph (3) excludes all income from research conducted by an organization operated primarily for the purpose of carrying on fundamental, as distinguished from applied, research and the research results are freely available to the general public.
  - d. Subparagraph (4) reiterates that the income of an organization from ordinary testing incidental to commercial or industrial operations is not excludable as income derived from scientific research in the public interest.
- (2) Section 512(b)(7) provides that in computing the unrelated business income tax (UBIT) there shall be excluded all income derived from research for:
  - a. The United States
  - b. Its agencies or instrumentalities
  - c. Any state or political subdivision
- (3) While the section itself is straightforward, the problem is determining whether the section applies to a particular research project.

### **C.4. Example, Research for Governmental Entity**

- (1) TAM 8028004 describes a project funded by a public utility that is a department of the city of Q.

The aim of the project is to determine the commercial feasibility of solar hot water heaters. If the solar hot water heaters are commercially feasible, the public utility plans to eventually market them to its customers.

The District Office sought to impose the UBIT on the income derived by the exempt organization from performing the feasibility study on the theory that the project was ordinary testing incidental to the commercial activity of marketing the solar hot water heaters.

The National Office agreed that the activity was not scientific research in the public interest.

Income from the project was not subject to the UBIT because the project was conducted for the city of Q and was, therefore, described in Section 512(b)(7).

- (2) Rev. Rul. 60-384, 1960-2 C.B. 172, reiterated that a state or municipality itself would not qualify as an organization described in Section 501(c)(3) since its purposes are clearly not exclusively those described in Section 501(c)(3). This revenue ruling further established that an organization that is operated as an integral part of a state or municipal government is not eligible for Section 501(c)(3) exemption, even if it is separately established and it satisfies the organizational test. Such organization, referred to as an instrumentality, is treated similarly as the government of which it is a part and, therefore, does not qualify as a Section 501(c)(3) organization.

The ruling provides that even though a wholly owned state or municipal instrumentality may be a separately organized entity, it is not entitled to exemption if it is clothed with powers other than those described in Section 501(c)(3).

Three generally acknowledged sovereign powers by which the government exercises its authority are:

- a. Power to tax
- b. Power of eminent domain
- c. Police power

Rev. Rul. 60-384, also provides that on the other hand, a wholly-owned state or municipal instrumentality which is a counterpoint of an organization described in Section 501(c)(3), such as a separately organized school, college, university, or hospital may qualify for exemption under Section 501(c)(3) as long as it doesn't have powers other than those described in Section 501(c)(3).

## **C.5. Research for Hospitals, Colleges or Universities**

- (1) Sections 512(b)(8) and (9) provide exclusions from the calculation of Unrelated Business Income including the direct expenditures associated with such activities.



- a. Section 512(b)(8) provides an exclusion from unrelated business income tax (UBIT) in the case of a college, university, or hospital for all income derived from research performed for any person.
  - b. Section 512(b)(9) provides that, in the case of an organization operated primarily for purposes of carrying on fundamental research the results of which are freely available to the general public.
- (2) The term fundamental research, as contrasted with applied research, does not include research carried on for the primary purpose of commercial or industrial application. See Treas. Regs. 1.501(c)(3)-1(d)(5)(i) and 1.512(b)-1(f)(4).
  - (3) Issues arise with surprising frequency under Section 512(b)(8) because organizations involved in research activities often have some relationship to or connection with a college, university, or hospital. Identification of unrelated business income and/or expense allocation may be questionable.

### **C.6. Example, Research Related to Colleges and Hospitals**

- (1) *Mayo Clinic v. United States*, 412 F. Supp. 3d 1038 (D. Minn. 2019), is currently active in the appeals process. This is an example where passive income of an institute was deemed, by the government, to be unrelated business income by failing the primary-function and merely incidental test requirements in Treas. Reg. 1.170A-9(c)(1). This case demonstrates the need to obtain all relevant facts and circumstances, to clearly document your case file and to apply the tax law to the relevant facts and circumstances when developing your case.
- (2) Government's Position
  - a. A tax-exempt organization under Section 501(c)(3), operating as a parent organization of several hospitals, clinics, and a college of medicine and science comprised of five distinct medical schools that offered M.D., Ph.D., and other degrees, as well as residencies, fellowships, and continuing medical education, brought a tax refund suit, alleging that it qualified as an educational organization and thus was entitled to a tax-exemption for certain passive income.
  - b. The Government concedes that Mayo, "normally maintains a regular faculty and curriculum and normally has a regularly enrolled body of pupils or students in attendance at the place where its educational activities are regularly carried on." See USA Mem. in Supp. at 5–6.
  - c. The Government's position - that Mayo is not entitled to the refunds it seeks - is premised entirely on Mayo's alleged inability to satisfy the primary-function and merely incidental requirements in Treas. Reg. 1.170A-9(c)(1). The Government argued that Mayo's "educational activities are merely incidental to [its] medical practice" and not its primary purpose and its income should not be excluded from unrelated business taxable income under section 512(b)(8).

- d. Congress, in excluding university research from taxation, anticipated that the purpose of such research, as reflected in the regulations, would be related to the primary exempt purpose of a university, such as, instructing students. If such research led to private contracts, the university would not be required to separate these out for unrelated income tax purposes.
- (3) Taxpayer's Position
- a. Mayo argues that the requirements of Treas. Reg. 1.170A-9(c)(1) exceed the bounds of authority given by Section 170(b)(1)(A)(ii) making them unlawful. Thus, there is no genuine issue of material fact that Mayo qualifies as an "educational organization" under Section 170(b)(1)(A)(ii) and is entitled to summary judgment on its refund claims.
- (4) This case was appealed to the Eighth Circuit Court of Appeals as Mayo Clinic v. United States, 997 F. 3<sup>rd</sup> 789 (8th Cir. 2021). The Eighth Circuit Court of Appeals embarked on a survey of the history and evolution of tax-exemption law for charities in the US (1894-present). This perspective led the court to conclude that terms such as "primary function" and "merely incidental" activities "have a valid role in interpreting the statute." It wrote that "it is reasonable -- in our view necessary -- that 'educational organization' in Section 170(b)(1)(A)(ii) be construed as one that is 'organized and operated exclusively for' one or more qualifying charitable uses." Thus, the court wrote that "it is valid to interpret the statute as requiring that a qualifying organization's primary purpose be 'educational' and that its noneducational activities be merely incidental to that primary purpose."
- (5) The circuit court remanded the case back to the district court to address the following, "how to measure educational activity as opposed to noneducational activity, as well as the degree to which education must be Mayo's primary purpose."
- (6) For an in-depth discussion on UBI and the treatment of income under Treas. Reg. 1.170A-9(c)(1) see TG 48, Unrelated Trade or Business and Taxation of Unrelated Business Income.

## V. Examination Techniques

- (1) The following techniques are specific to:
- a. Identified issues
  - b. Examples of documents to request
  - c. Key interview questions
  - d. Observations during the tour of business
  - e. Inspections of books and records
  - f. Other known sources of relevant information.

## **A. Determining Exemption under Section 501(c)(3)**

- (1) During examinations of 501(c)(3) organizations, examiners are responsible for determining if the organization:
  - a. Meets the requirements for exemption
  - b. Has the proper foundation status
  - c. Has filed all required tax and information returns
  - d. Has completely and accurately reported information and tax liabilities on filed returns.
- (2) In conducting an examination of an organization exempt under Section 501(c)(3) and developing the facts of the case, it is best practice to follow the Internal Revenue Manual; IRM 4.75.13, Issue Development and Conclusion.

### **A.1. Conducting the Organizational Test**

- (1) The organizational test relates to an entity's organizing document which should limit the purpose of the organization and not allow the organization to engage in, other than an "insubstantial part," non-exempt activities.
- (2) Upon reviewing the organizing documents and directors' minutes, conduct the organizational test in accordance with Treas. Reg. 1.501(c)(3)-1(d).
- (3) Determine if:
  - a. Exempt purpose listed in organizational documents meet requirements of Treas. Reg. 1.501(c)(3)-1(d)(1).
  - b. Organizing documents provide for activities that are not exclusively for exempt purposes. If allowed, non-exempt activities are insubstantial or a furtherance of its exempt purpose, in addition to simply providing funds to the organization.
  - c. Documents allow for the benefit of the public rather than private interests as defined by Treas. Reg. 1.503(c)(3)-1(d)(1)(ii).
  - d. Articles restrict legislative activities and prohibit political activities as defined by Treas. Reg. 1.503(c)(3)-1(b)(3).
  - e. Organizing documents contain a dissolution clause in compliance with Treas. Reg. 1.503(c)(3)-1(b)(4).
- (4) Upon completing the organizational test, expand the examination scope to address any non-compliance issues with the organizing documents, discuss your findings with your manager, and determine if the organization can be brought into compliance, or if revocation is necessary.

## **A.2. Conducting the Operational Test**

- (1) To be considered “operating in accordance with Section 501(c)(3)” the organization must meet the requirements of Treas. Reg. 1.501(c)(3)-1(c), the Operational Test.
- (2) The operational test is related to an organization’s activities. The organization must engage primarily in activities that further its exempt purpose.
- (3) Exempt purposes as described in Section 501(c)(3) include, but are not limited to, religious, charitable, scientific, and educational purposes. An organization must be operated exclusively for one or more of the stated purposes to satisfy the operational test.
- (4) Upon review of the organization’s activities the examiner must determine if:
  - a. The organization is operated exclusively for exempt purposes
  - b. The net earnings inure to individuals. An organization is not operated exclusively for one or more exempt purposes if its net earnings inure in whole or in part to the benefit of private shareholders or individuals
  - c. The organization is an "action organization" as defined by Treas. Reg. 1.501(c)(3)-1(c)(ii) if a substantial part of its activities is attempting to influence legislation by propaganda or otherwise. An organization is not operated exclusively for one or more exempt purposes if it is an action organization.

## **A.3. Tips on Identifying Activities**

- (1) An organization may be engaged in more than one activity. While some of the activities are clearly directed toward exempt purposes, others may not.
- (2) If the organizations activities are directed toward Section 501(c)(3) purposes, its exempt status would be continued. If, however, the organization’s activities further a substantial non-exempt purpose it would not satisfy the organizational test, and therefore, it would not qualify for exemption.
- (3) Identify, isolate, and quantify activities using information sources such as:
  - a. Organizational documents, including articles of incorporation, by-laws, and determination letter
  - b. Administrative record, including Form 1023, Application for Exemption
  - c. Minutes of the board and specific committees
  - d. Initial interview and subsequent interviews
  - e. Research grants
  - f. Newsletters, pamphlets, and brochures
  - g. Tour of facilities

- h. Organization's website
  - i. General Internet searches, including news articles
  - j. Financial books and records of original entry
  - k. Financial statements, including notes to financial statements
  - l. Staffing patterns to specific projects as evidenced in the payroll system
  - m. Reporting to other governmental agencies
- (4) When conducting an examination, identify each of the organization's activities and determine the extent for each activity in relation to all of the organization's activities. Follow Section 512(a)(6) to silo the income and expenses allocated to each activity and to determine overhead allocation to exempt and non-exempt activities.

To do this, use the following criteria:

- a. Income earned by activity from all sources
- b. Liabilities incurred for each activity
- c. Assets devoted to each activity
- d. Staff time devoted to each activity

#### **A.4. Examination Techniques Specific to SROs**

- (1) To determine the nature of the organization's activities and if the activities further an exempt purpose or that of a commercial enterprise one may use the following examination techniques.
- (2) Examine financial records.
  - a. Examine catalogues or lists of the organization's projects or plans to determine the kinds of research in which the organization engages.
  - b. Examine corporate minutes, agreements, and other available documentation to determine if the organization owns (directly or indirectly) or controls more than an insubstantial portion of the patents, copyrights, processes, or formulae resulting from its research and doesn't make these patents, copyrights, processes, or formulae available to the public. Determine how the organization selects projects. If nearly all projects are performed for one firm, the organization may be serving a private rather than a public interest.
  - c. Review payments to identify sponsors. Review agreements and contracts with sponsors. Identify any private interests being served.
  - d. Interview officers and directors and determine if research is performed only for individuals who created (directly or indirectly) the organization.
  - e. Look for large and recurring donations by a particular firm. Determine if any payments were made for services rendered.

- f. Check payroll records to determine if any non-qualified persons occupy well-paid positions, possibly a way to disburse the organization's funds for non-exempt purposes.
- (3) Inspect membership lists to determine:
- a. Rights or privileges of members
  - a. Exclusive access granted to members
  - b. Committees and advisory boards staffed by members
- (3) Review project contracts or grants to:
- a. Uncover any commercial firm grants.
  - b. Determine if the project involves scientific research rather than commercial or industrial testing.
  - c. Determine if the organization will make results of the scientific research available to the public in a nondiscriminatory manner. See Rev. Rul. 76-296, 1976-2 C.B. 141.
  - d. Identify the standards the organization uses to differentiate scientific from nonscientific research projects.
  - e. Examine the completed research materials for evidence of private ownership.
- (4) Examine the articles of organization, lease agreements, contracts, payroll records, bylaws, and minutes for possible relationships between the exempt organization and a commercial firm.
- (5) Indications that a commercial firm controls the exempt organization include:
- a. Interlocking directorates (minutes, bylaws, and so on).
  - b. Sharing staff and facilities (lease agreements, contracts, payroll records, indications of allocation of expenses between the exempt organization and the commercial firm).
  - c. Large and recurring donations from a particular firm (financial records).
- (6) If the organization has any scientific research projects that clearly don't fall within the categories of "scientific research in the public interest," such as ordinary testing incident to commercial or industrial operations, determine if:
- a. Activity relates or doesn't relate to attaining the organization's exempt purpose
  - b. Activity constitutes a trade or business
  - c. Activity is regularly carried on
  - d. Income from the unrelated business activity is excluded from tax by the exceptions and exclusions of Section 512(b)

- (7) Review sources of income to determine if the organization engages in research and whether they're exclusively scientific per Section 501(c)(3).

## **A.5. Determining if Activities Further an Exempt Purpose**

- (1) After identifying and determining the extent of the effort put into each activity, ascertain whether the activity furthers the organization's exempt purposes. Some factors to consider are:
  - a. Manner the activity is conducted
  - b. Existence of competition with commercial firms
  - c. Whether activity serves public or private interests
  - d. Ownership of patents, copyrights, processes, or formulae derived from the organization's research
- (2) For an in-depth discussion on patents, copyrights, trademarks, and the like, refer to the 1990 EO CPE article on Intellectual Property found in the Knowledge Management 501(c)(3) library.

## **A.6. Tips on Developing Examination Issues**

- (1) When developing issues in accordance with IRM 4.75.13.2, Developing the Facts, consider the following:
  - a. Conduct research on the activities of the organization prior to contacting the organization and throughout the examination.
  - b. Fully document all conversations with the organization's representatives.
  - c. Ask follow-up and clarifying questions and summarize responses to ensure you completely understand the transaction and activities, and that your questions have been fully answered.
  - d. Put your questions in writing through the use of Information Document Requests and follow up to remind the organization to respond.
  - e. Request copies of contracts and the organization's policy on ownership or control of any patents, copyrights, processes, or formulae resulting from the organization's research.
  - f. Obtain copies of all pertinent documents and do not make any marks on them. Unmarked taxpayer documents are required for the administrative record if an adverse action is taken. If you wish to use the documents as a work paper, make a working copy and identify it as such on the top of the document.
  - g. Utilize online resources such as Bloomberg and Westlaw located under ReferenceNet Legal and Tax Research Services SharePoint site.

- h. To assist with planning your examination, develop a decision tree to determine if the activities carried on constitute unrelated business activities and if activities are statutorily exempt from income tax.

## B. Recognizing Inurement or Private Benefit

- (1) IRM 4.75.13.2(4) states developing facts in a case also includes identifying and documenting transactions that result in:
  - a. Inurement under Treas. Reg. 1.501(c)(3)-1(c)(2).
  - b. Impermissible private benefit under Treas. Reg. 1.501(c)(3)-1(d)(1)(ii).
  - c. Excess benefit transactions under Section 4958.

### B.1. Identifying Disqualified Persons

- (1) A person is a disqualified person as to an applicable tax-exempt organization, if the person was in a position to exercise substantial influence over the affairs of the organization at any time during the five-year period ending on the date of the excess benefit transaction (the “Lookback Period”), but not before September 14, 1995. See Treas. Reg. 53.4958-3(a)(1).
- (2) A person who holds certain powers, responsibilities, or interests as to an applicable tax-exempt organization, regardless of the person’s title, is in a position to exercise substantial influence over the affairs of an applicable exempt organization. See Treas. Reg. 53.4958-3(c).
- (3) In determining whether any other person is a disqualified person as to an applicable tax-exempt organization, agents should consider all relevant facts and circumstances.
  - a. Some of the relevant facts and circumstances tending to show that a person has substantial influence over the affairs of an organization are included in Reg. 53.4958-3(e)(2).
  - b. Some of the relevant facts and circumstances tending to show that a person does not have substantial influence over the affairs of an organization are included in Reg. 53.4958-3(e)(3).
- (4) In considering all the relevant facts and circumstances to determine whether a person is a disqualified person as to an applicable tax-exempt organization, it is not required that a person actually exercised substantial influence over the affairs of an organization, only that the person was in a position to exercise substantial influence.
- (5) In *Vincent J. Fumo v. Commissioner of Internal Revenue*, T.C. Memo 2021-61, 17614-13, (May 17, 2021), the court held that Petitioner, a former state legislator, “is a **disqualified person** under Section 4958 with respect to a Section 501(c)(3) organization,” although he held no title or position within the organization. The court held that Petitioner was “in a position to exercise



substantial influence over the affairs of an organization.” (Bold added for emphasis).

- (6) *Fumo v Commissioner* is a prime example of developing the facts and circumstances to support your conclusions. Although Petitioner did not hold a title or paid position within the organization, the following facts and circumstances support that the former state legislator was indeed a disqualified person for purposes of Section 4958 for he:
- a. Was the founder
  - b. Was a substantial contributor
  - c. Authorized a substantial portion of its capital expenditures or operating budget
  - d. Managed a substantial portion of its activities, assets income or expenses
  - e. Used his status and position within the state legislature to obtain government funding

See TG 65, Excess Benefit Transactions for a fuller explanation of disqualified persons and TG 63 Disqualified Persons as Defined in IRC 4946.

- (7) During your examination, request and review the following items. These are excellent sources that an examiner may use to gain a true understanding of the organization’s activities:
- a. Newsletters and trade journals
  - b. Organization’s website and websites of trade journals
  - c. Brochures or flyers
  - d. Newspaper clippings or articles about the organization
  - e. Advertisements
  - f. Literature
- (8) During your examination, the following questions and issues should be addressed.
- a. Who will benefit?
  - b. Is the benefit for the general public or is it for private interests?
  - c. How much benefit is given? Is it substantial or insubstantial?
  - d. Is the benefit limited to a particular group or geographic area?

## **B.2. Tips on Identifying Inurement**

- (1) Inurement may exist in many forms. Some examples are:
- a. Unreasonable compensation
  - b. Payment of excessive rent

- c. Detained or retained interests
  - d. Receipt of less than fair market values in sales or exchange property
  - e. Unsecured or inadequately secured loans
  - f. Prohibitive benefit from funds
  - g. Exempt organizations providing capital improvements to property owned by its insiders
  - h. Copyrights and royalties benefiting insiders
  - i. Interest free and/or unsecured loans to insiders
  - j. Dividends
- (2) As an examiner, it is imperative that one looks for possible areas of inurement. Prior to taxpayer contact, request and review the administrative file following IRM 4.75.10.6.2, Request the Determination Administrative File. Compare the Form 1023, Application for Recognition of Exemption Under Section 501(c)(3) of the Internal Revenue Code, and organizing documents to the Form 990, Return of Organization Exempt From Income Tax, for changes in activities, funding streams and expenditures for signs of possible inurement.
- (3) As one develops a case by examining the books and records, conducting interviews, and reviewing contracts and other documents, it's important to answer the following questions.
- a. What activities are being conducted by the organization?
  - b. Are the activities directly associated with the organization's stated exempt purpose?
  - c. Do the activities further the exempt purpose of the organization?
  - d. Is the research a commercial activity?
  - e. Who benefits from the activities?
  - f. Who controls the organization – who are the insiders?
  - g. Is compensation paid to insiders? Does the organization's board have broad representation from the community it serves? Or is the board dominated by one or two individuals or families?
  - h. Who is compensated? Based on the information provided, was the compensation negotiated at arm's length? Is it reasonable?
  - i. Carefully analyze any written agreements or contracts, are the terms negotiated at arm's length?
  - j. What are the benefits of the organization and who receives them?
  - k. Are there copyrights, patents and so forth? Who owns them?

- (4) In addition to reviewing the Form 1023 application and Form 990 returns, an examiner should also review the following supporting documents:
- a. Organizing document – This document should show who controls the organization, the purpose of the organization and if dividends will be distributed.
  - b. Bylaws - This document will normally describe the organizational structure of the organization. For example, listing of officer titles along with their duties and responsibilities.
  - c. Determination letter - A written statement the EO Determinations office issues to an organization that applies tax laws to a specific set of facts on matters described in Rev. Proc. 2022-5 (updated annually).
  - d. Case notes and case chronology record of the EO Determinations' specialist, to determine if there were any adverse issues or corrections to the application that were required to be resolved prior to issuance of the determination letter.

Inquire if any changes to the organizing documents were made and request the amended articles of incorporation and revised by-laws.

- (5) Follow IRM 4.75.10.7, Form 4564, Information Document Request (IDR), procedures and interim guidance on best practices. Request and review the following documents to determine if the organization has entered into any activity that may provide private benefit or inurement:
- a. Contracts
  - b. Rental or leasing agreements
  - c. Copyrights
  - d. Patents
  - e. Loans
  - f. Deeds
- (6) When reviewing the above items, the following issues may be addressed:
- a. Is it reasonable?
  - b. Is it well documented?
  - c. Was it negotiated at "arm's length"?
  - d. Who negotiated it?
  - e. Who will have ultimate control?
  - f. Who will benefit?
  - g. Who has final approval?
  - h. Is there a conflict of interest?

- (7) Follow IRM 4.75.13.4, Evidence, and IRM 25.5, Summons for third-party contact and summons procedures. See Summons Basics on the KM Fraud Knowledge Base, Summoning for detailed instructions on issuing and enforcing a summons.
- (8) As an examiner, it's one's responsibility to take the facts presented by the organization, apply tax law to those facts and determine if the organization remains organized and operated in accordance with Section 501(c)(3). Case files should be fully developed and documented to ensure the requirements of the law are met.
- (9) In cases where inurement exists, revocation of exemption under Section 501(c)(3) will be pursued. Follow IRM 4.75.13.8.1, Revocation of Tax-Exempt Status. Discuss the case with your group manager and obtain approval to propose revocation and seek Counsel's assistance, when needed.

### **B.3. Tips on Identifying Private Benefit Transactions**

- (1) Treas. Reg. 1.501(c)(3)-1(d)(1) states, in part, that an organization is not organized or operated exclusively for one or more exempt purposes: "...unless it serves a public rather than a private interest. Thus, to meet the requirement of this subsection, it is necessary for an organization to establish that it is not organized or operated for the benefit of private interests such as designated individuals, the creator or his family, shareholders of the organization, or persons controlled, directly or indirectly, by such interests."
- (2) Prior to taxpayer contact, follow IRM 4.75.10.6.2, Request the Determination File, to request and review the determination administrative file. When reviewing the administrative file and Form 990 returns, the examiner should look at all activities closely to determine if the organization serves public rather than private interests.
- (3) The burden of proof is on the organization under examination. It must provide adequate documentation to demonstrate that its activities benefit the public.
- (4) When reviewing the determinations administrative file and Form 990 return, the examiner must determine who benefits from the organization's activities, the general public or private individuals. The mere existence of private benefit may not endanger the exemption. The examiner must look at the facts and circumstances and analyze:
  - a. The amount of the private benefit.
  - b. How the benefit is given or received.
  - c. Whether the benefit is limited to a particular group or geographical area.
- (5) Sometimes, organizations provide personal services that are unrelated to their exempt purposes. These organizations must be examined closely. Depending on how substantial the service is, this type of private benefit may endanger the

organization's exemption. Conduct a facts and circumstances test to determine if private benefit is present during your examination.

See TG 3-10, Disqualifying and Non-Exempt Activities, Trade or Business Activities IRC 501(c)(3) for additional information on private benefit.

## **C. Tips on Identifying Excess Benefit Transactions**

- (1) Treas. Reg. 53.4958-1(b) defines excess benefit as, "the amount by which the value of the economic benefit provided by an organization directly or indirectly to or for the use of any disqualified person exceeds the value of the consideration (including the performance of services) received for providing such benefit."
- (2) Examples of possible excess benefit transactions of a Section 501(c)(3) organization with a disqualified person are:
  - a. Entering into unreasonable compensation packages
  - b. Receiving reimbursements for personal expenses
  - c. Personal use of vehicles
  - d. Personal use of real property
  - e. Excessive rents on lease of disqualified person's owned real property to organization
  - f. Loans to disqualified persons
  - g. Repayment of loans to disqualified persons
  - h. Payment of personal expenses of family members
  - i. Transacting with for-profit company controlled by disqualified person
  - j. Publication of a book by organization and the disqualified person receives royalties, not reported as compensation

### **C.1. Reporting Requirements**

- (1) Section 501(c)(3) organizations are required to report annually certain information regarding excess benefit transactions under Sections 4958, 6033(b)(11), 6033(b)(12) and 6033(b)(13). See Treas. Reg. 1.6033-2 for more detail.
- (2) Section 501(c)(3) organizations under Section 6033(b)(14) and Treas. Reg. 1.6033-2(i)(2) are required to report other information the Service may require for purposes of carrying out the internal revenue laws.
- (3) Form 990, Part VI, and Form 990-EZ, Part V ask Section 501(c)(3) organizations the following:

- a. Did the organization engage in any Section 4958 excess benefit transaction during the year, or did it become aware of an excess benefit transaction from a prior year?
  - b. If “Yes,” attach a statement explaining each transaction; most commonly entered on Schedule O.
- (4) If the organization reported excess benefit transactions, determine if Form 4720, Return of Certain Excise Taxes on Charities and Other Persons Under Chapters 41 and 42 of the IRC, (MFT 50) and Forms 4720-A (MFT 66) were filed using BMFOLT. If the organization and/or disqualified person is subject to excise tax and failed to file Form 4720 or Form 4720-A, you may use Substitute for Return (SFR) procedures to establish the returns. Follow:
- a. IRM 4.75.15.8.8, Non-Private Foundation Excise Taxes
  - b. IRM 4.75.22.9, Delinquent and SFR Forms 4720 and 4720-A
  - c. IRM Exhibit 4.75.15-11, Chapter 41 and 42 Excise Tax Reference Chart - Non-Private Foundations.

## **C.2. Assessing Section 4958, Intermediate Sanctions**

- (1) Chapters 41 and 42 imposes several excise taxes on non-private foundations. The IRC imposes some of these taxes on specified exempt organizations and some on their disqualified persons and organization managers. Section 4958 assesses a tax on the disqualified persons and organization manager for entering into excess benefit transactions.
- (2) A qualifying organization that has entered into an excess benefit transaction is required to file Form 4720. Although the tax is assessed against the disqualified person and the organization manager, the organization must file Form 4720 (MFT 50) as an information return. Form 4720, Part II-A, is used as the source of information to create Form 4720 (MFT 66). Form 4720 Part II-A consists of all persons who owe tax in connection with the organization, whether as managers or disqualified persons or related persons. Form 4720 is filed under the organization’s employer identification number (EIN) and the return is established as master file for tax years beginning on or after January 1, 2020.
- (3) The disqualified persons, and organization managers subject to excise taxes on excess benefit transactions are to file Form 4720, separately.
  - a. See IRM 21.7.7.6.11.3 for instructions on completing Form 4720 and establishing the return as master file, MFT 66, under the individual’s social security number followed by a V.
  - b. Each party is required to complete Schedule I, Part I by providing:
    - Date of the transaction
    - Description of the excess benefit transaction
    - Transaction amount

- Computation of tax on the excess benefit for disqualified persons, and
  - Computation of tax for the organization managers.
- c. The names of all disqualified persons who took part in the excess benefit transactions are listed under Schedule I, Part II. If more than one disqualified person took part in an excess benefit transaction, each is individually liable for the entire tax on the transaction, also known as jointly and severally liable. But the disqualified persons who are liable for the tax may prorate the payment among themselves.
- d. Follow IRM 21.7.7.6.11.2, Penalties Applicable to Form 4720 for accessing and abating applicable penalties.
- (4) Follow IRM 4.75.15.8.8, Non-Private Foundation Excise Taxes, to assess the tax.
- (5) For additional information on intermediate sanctions see:
- a. TG 3-10, Disqualifying and Non-Exempt Activities, Inurement and Private Benefit
  - b. TG 65, Excess Benefit Transactions, IRC 4958
  - c. 501(c)(3) Knowledge Base, Excise and Other Taxes, IRC 4958 Excess Benefit Transactions

## **D. Identifying Unrelated Business Activities**

- (1) Income received by an exempt organization from activities not related to their exempt purpose may be subject to Federal income tax. Activities not related to an exempt purpose of the organization could have an adverse tax effect and possibly bar an organization from retaining exemption.

### **D.1. Filing Checks**

- (1) With respect to returns of exempt organizations, examiners must determine:
- a. Whether an organization is liable for a particular return.
  - b. Whether to solicit a delinquent return.
  - c. Whether to solicit an amended return.
  - d. What to do if a delinquent or amended return is secured.
  - e. Whether to examine a secured delinquent or amended return.
  - f. Whether to pursue substitute for return procedures.
- (2) Follow IRM 4.75.15.8.5, UBIT and Other Income Taxes, in determining unrelated business activities and IRM 4.75.22.5, Delinquent Return Secured, procedures for securing and processing delinquent Forms 990-T, Exempt Organization Income Tax Return.

## **D.2. Form 990-T, Exempt Organization Income Tax Return**

- (1) A tax-exempt organization which has income from an unrelated business activity is required to file a Form 990-T, Exempt Organization Business Income Tax Return. This return is filed separately from the Form 990. However, the due date for filing this return is the same as a Form 990 which is the 15th day of the fifth month following the close of their tax year. Usually the Form 990-T return is filed at the same time as the Form 990 return.
- (2) An automatic 6-month extension may be requested; however, the organization must pay any tax owed by the 15th day of the fifth month. Failure to pay penalties and estimated tax penalties apply for delinquent tax payments.
- (3) The organization is required to file this return only if it has \$1,000 or more in gross receipts from an unrelated business activity. The Code provides for a specific deduction of the first \$1,000 of gross receipts from an unrelated business activity. This specific deduction is in addition to any expenses incurred to produce the unrelated business income. Thus, even if there were no related expenses, there would never be a tax liability if the gross receipts from the unrelated business activity were below \$1,000.
- (4) As previously mentioned, for tax years beginning after December 31, 2017, an organization that regularly carries on two or more unrelated business activities, must separately compute its unrelated business taxable income with respect to each unrelated trade or business, including for purposes of determining any net operating loss deduction.
- (5) Form 990-T has been redesigned for tax year 2020. Each unrelated trade or business of an organization has a separate Schedule A attached to the return, with a list of how many Schedules A are attached. Each separate trade or business may be classified by a 2-digit North American Industry Classification System (NAICS) code. See Treas. Reg. 1.512(a)-6(b)(1), regarding use of 2-digit NAICS codes.
- (6) As a best practice, review the instructions to Form 990-T and familiarize yourself with the revised form. Forms and the corresponding instructions may be found on the Published Product Catalog under the Find a Product tab.
- (7) The unrelated income tax rates payable by most tax-exempt organizations are the corporate rates as reported on Form 1120, U.S. Corporation Income Tax Return. Refer to the Instructions for Form 1120 for the applicable tax year for the most current Tax Rate Schedule.
- (8) A Form 990-T filed by an organization exempt under IRC section 501(c)(3) after August 17, 2006, is open for public inspection. Refer to Notice 2008-49.

## **D.3. Selling Endorsements**

- (1) An example of unrelated business income earned by an exempt scientific organization is where an organization enjoys an excellent reputation in the field



of biological research which regularly exploits this reputation by selling endorsements of laboratory equipment to manufacturers.

- (2) Endorsing laboratory equipment does not contribute importantly to the accomplishment of any purpose for which exemption is granted to the organization. Accordingly, the sale of endorsements is an unrelated trade or business and the income derived therefrom is subject to the tax imposed by Section 511.

#### **D.4. Dual use of Assets or Facilities**

- (1) The mere fact that that an asset or facility is used both in a commercial endeavor and the conduct of an exempt function does not, standing alone, make the income derived from the commercial endeavor gross income from a related trade or business.
- (2) Instead, the test is whether the activities productive of the income in question contribute importantly to the accomplishment of exempt purposes.

#### **D.5. Allocation of Expenditures**

- (1) Treas. Reg. 1.512(a)-1(c) provides that where facilities are used to carry on both exempt and unrelated activities; expenses, depreciation and similar items attributable to such facilities 'shall be allocated on a reasonable basis' between the uses, and the portion of any such item so allocated to the unrelated trade or business 'is proximately and primarily related' to that business activity and is allowable as a deduction in computing UBTI.
- (3) In *Rensselaer Polytechnic Institute (RPI) v C.I.R.* AOD 1987-14 (IRS Action on Decision), the court agreed with RPI's method of allocating on the basis of actual usage, finding it to be reasonable within the meaning of the regulation. See *Rensselaer Polytechnic Institute v. Commissioner*, 732 F.2d 1058 (2d Cir. 1984), affirming 79 T.C. 967 (1982).
- (4) In response to the argument that this method of allocation was inconsistent with the statutory directly connected with requirement, the court stated that the government's position would involve a more stringent interpretation of 'directly connected with' for purposes of Section 512 than generally was applied with respect to the deductibility of ordinary and necessary business expenses.
- (5) The government's position is:

We continue to believe that fixed expenses should not be allocated on the basis of actual usage. The proper method of allocation of the fixed expenses should be to allocate between exempt and unrelated use on the basis of a 24-hour-a-day, 12-month-a-year period, with an allocation ratio of hours used for unrelated activities over the total number of hours in the year.

However, we now believe that this issue should not be litigated until the allocation rules of Treas. Reg. 1.512(a)-1(c) are amended. As long as the language permits an allocation between exempt and unrelated uses on a reasonable basis, it may be difficult for the Internal Revenue Service to prevail on this issue in another circuit.

As of this writing, the government has not amended Treas. Reg. 1.512(a)-1(c) and reasonableness must be considered when proposing adjustments.

- (6) For additional guidance on unrelated business income the following technical guides:
  - a. TG 3-10, Disqualifying and Non-Exempt Activities, Trade or Business Activities, IRC 501(c)(3)
  - b. TG 48, Unrelated Business Income Tax

## **VI. Additional Information**

### **A. Resources**

- (1) The following are additional resources and training materials to aid you with conducting a thorough examination of Exempt Organizations.
- (2) Training material can be found on the TE/GE Connect, Training SharePoint.

#### **A.1. Internal Revenue Manual Reference**

- (1) IRM references concerning identifying and resolving exemption issues.
  - a. IRM 7.20.2, Exempt Organizations Determination Letter
  - b. IRM 21.7.7.4 Exempt Organizations Overview
  - c. IRM 4.75.11, On-sight Audit Guidelines
  - d. IRM 4.75.13, Issue Development and Conclusion

#### **A.2. Exempt Organizations, Determination Training**

- (1) Classroom training sessions provided to newly hired trainees to EO Determinations.
  - a. EOD Unit 1A L1, Introduction to Exempt Organizations
  - b. EOD Unit 1A L8, Introduction to Section 501(c)(3)
  - c. EOD Unit 1A L9, Operational Test
  - d. EOD Unit 1A L10A, Charitable Organizations, Purposes
  - e. EOD Unit 2 L11, Overview of Grade 13 Case Topics

### **A.3. Exempt Organizations, Examinations Training**

- (1) Classroom training sessions provided to newly hired trainees to EO Examinations.
  - a. EOE Module H, L1, Exemption Requirements for 501(c)(3) Organizations

### **A.4. Continuing Professional Education**

- (1) Continuing Professional Education Training (CPE) is provided to all EO Examination Revenue Agents. CPE is conducted on a continuous basis and presented using a virtual platform. Prior to 2006 CPE was conducted as classroom training and training manuals were published. CPE is now presented virtually using a PowerPoint slide deck.
  - a. EO CPE 1988, 501(c)(3) Organizations and Publishing
  - b. EO CPE 1986, Exempt Purposes, Scientific
  - c. EO CPE 1986, For Profit Subsidiaries
  - d. EO CPE 1990, Instrumentalities
  - e. EO CPE 1999, Intellectual Property
  - f. EO CPE 2001, Private Benefit under Section 501(c)(3)
  - g. EO CPE 2004, "Automatic" Excess Benefit Transactions under Section 4958

### **A.5. Publications**

- (1) IRS Publications are informational booklets, written in plain language to provide guidance to taxpayers on specific subjects as it pertains to tax law and tax compliance. Publications can be found on the Forms and Publications Repository.
  - a. Publication 557, Tax-Exempt Status for Your Organization
  - b. Publication 598, Tax on Unrelated Business Income of Exempt Organizations
  - c. Publication 4220, Applying for 501(c)(3) Tax-Exempt Status
- (2) Congressional research service reports (CRS) are research projects conducted under Congressional oversight and directed by members of Congress on specific issues. The CRS reports are included as additional research material. The reports are made public, and available on <https://crsreports.congress.gov>.
  - a. CRS, US Land-Grant University System, R45897
  - b. CRS, Agency-Related Nonprofit Research Foundations and Corporations, R46109